No. 12,391

IN THE

United States Court of Appeals

For the Ninth Circuit

AGNES M. KANNE, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellant,*

vs.

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellee,*

and

AMERICAN FACTORS, LIMITED (an Hawaiian corporation), *Appellant,*

vs.

AGNES M. KANNE, Executrix under the Will and of the Estate of Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, *Appellee.*

Upon Appeal from the United States District Court for the Territory of Hawaii.

BRIEF FOR APPELLANT, AMERICAN FACTORS, LIMITED.

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BRIEF FOR APPELLANT,
AMERICAN FACTORS, LIMITED.

STATEMENT OF JURISDICTION.

This is a suit by American Factors, Limited, plaintiff-appellant, against Fred H. Kanne, Collector of Internal Revenue of the United States for the District of Hawaii, defendant, brought in the United States District Court for the Territory of Hawaii praying for the recovery of additional income taxes and interest thereon for the calendar year 1932, alleged to have been erroneously and illegally exacted from plaintiff by said Fred H. Kanne (Comp. R. 2-48; Ans. R. 48-50). After answer filed, defendant Kanne died and his Executrix, Agnes M. Kanne was substituted as defendant by order of court (R. 51-52).

Jurisdiction of the district court was granted at the time the suit was filed by 28 U.S.C. Sec. 41(5), which as now amended (new 28 U.S.C.) is Sec. 1340.

The judgment of said district court was entered on June 15, 1949 (R. 104-106) pursuant to the opinion of the court filed on March 18, 1948 (R. 59-66) and findings of fact and conclusions of law filed on June 15, 1949 (R. 67-104). Agnes M. Kanne, Executrix as aforesaid, defendant, filed notice of appeal to the United States Court of Appeals for the Ninth Circuit on August 4, 1949. American Factors, Limited filed notice of appeal to the United States Court of Appeals for the Ninth Circuit on August 15, 1949 (R. 108-109). Jurisdiction on appeal is provided in new 28 U.S.C. Sec. 1291.

STATEMENT OF THE CASE.

American Factors, Limited, plaintiff-appellant-appellee (hereinafter called "American Factors") is a Hawaiian corporation having its principal office in Honolulu, Territory of Hawaii. Fred H. Kanne was the Collector of Internal Revenue of the United States for the District of Hawaii and a resident of Honolulu at all times from on or about August 1, 1933 until his death on December 24, 1946 (R. 375). Agnes M. Kanne, the duly qualified and appointed executrix of the will and of the estate of Fred H. Kanne, deceased was substituted as defendant in the above cause by order of the district court on March 6, 1947 (R. 375, 50-52).

American Factors, for the purpose of computing its federal income taxes, is and has been at all times on the calendar year and accrual bases, and on the actual method of charging off bad debts (R. 394).

In its federal income tax return (Ex. P-6; R. 209-226) for the taxable year 1932, American Factors deducted the amount of $568,607.76 of Hackfeld litigation expenses (R. 201, 213, 222) and also the sum of $50,000.00 on account of a bad debt of Henry Waterhouse Trust Company, Limited written off during the year (R. 213, 394-395) and also $4,063.33 paid as pensions to widows (R. 97, 418-419) and children of former deceased employees, in computing its taxable net income (R. 201; Ex. P-6, R. 213). The Commissioner of Internal Revenue disallowed the Hackfeld litigation expense as a deduction, the bad debt deduction, and the pension deduction and assessed addi-

tional income taxes on account thereof, which together with interest thereon, American Factors paid to defendant Kanne upon his demand therefor (R. 201-202, 394-396).

The trial court, in its decision, allowed as a deduction $171,795.26 of the Hackfeld litigation expenses and disallowed the sum of $396,812.50 of said litigation expenses (R. 59-60, 63-64) and also disallowed the deduction of the bad debt of Henry Waterhouse Trust Company, Limited, but allowed the deduction of the pensions (R. 60-61, 64-65).

THE HACKFELD LITIGATION.

When the United States entered the First World War, H. Hackfeld & Company, Limited (hereinafter referred to as "Hackfeld Company"), was a Hawaiian corporation which was then conducting and had conducted for many years past a sugar plantation agency, general merchandise store and other businesses. It was a large factor in the Hawaiian sugar industry and in other businesses in the Territory of Hawaii. It was controlled by German interests. On or about January 28, 1918 and during March 1918, the Alien Property Custodian of the United States of America (hereinafter called the "Alien Property Custodian"), seized the stock of Hackfeld Company owned by German nationals and gained control either directly or indirectly of approximately 68½% of its capital stock (R. 68, 128, 179).

Prior to January 28, 1918, the business of Hackfeld Company had been seriously disrupted as a consequence of the restrictions placed upon it by the allied governments as a result of its German affiliations and those of its stockholders (R. 68, 129, 179-180).

The Alien Property Custodian sought and received the views of leading businessmen interested in the sugar industry and other businesses concerning the Hackfeld Company business (see *Isenberg v. Sherman,* 298 Pac. 1004 at 1011; 212 Cal. 454), and determined that the business should be continued as a unit and as a going concern, and that it must be wholly Americanized (R. 181). A plan for the reorganization of Hackfeld Company was formulated in the office of the Alien Property Custodian, which plan as afterwards perfected was fully set forth in a resolution adopted by the stockholders of the company on July 19, 1918 (R. 68-69, 180). The organization of American Factors, Limited as a new corporation to take over the businesses and assets of Hackfeld Company as a going concern and whose stock or trust certificates therefor were to be sold to American citizens was an integral part of said plan (R. 69, 180). In accordance with the plan, American Factors, Limited was created and had a capital stock of $5,000,000.00 divided into 50,000 shares of the par value of $100 each, which shares, pursuant to the plan, were issued to Hackfeld Company and were transferred to trustees to hold until three years after the expiration of the war, and trust certificates representing and entitling the holders thereof to receive all said shares

upon the termination of the trust were sold to bona fide American citizens or American corporations at a price of $150.00 for each share, or a total stated consideration of $7,500,000.00 (R. 69, 185).

Some 23 persons and corporations signed a joint subscription agreement under which each individually subscribed for trust certificates representing a certain number of shares of American Factors, Limited (R. 184). This joint subscription was for 27,000 shares, and it was conditioned upon this group collectively being allotted a minimum of 25,000 shares (R. 184-185). The joint subscription was accepted for a total of 25,000 shares and trust certificates were issued to and paid for by the subscribers of the joint subscription for a total of said 25,000 shares (R. 185). Trust certificates representing the other 25,000 shares were issued to and were paid for by approximately 614 other persons and corporations (R. 185). The total stated consideration of $7,500,000.00 representing the purchase price of the trust certificates for 50,000 shares was duly paid in cash or United States bonds at par to Hackfeld Company and all of its assets and businesses as a going concern were conveyed on August 20, 1918 to American Factors, Limited which assumed all liabilities of Hackfeld Company and of the business, and American Factors, Limited thereafter continued the business as a going concern (R. 185, 197-198).

About June, 1924, the directors of American Factors were informed that former stockholders of Hack-

feld Company, then dissolved, threatened to initiate litigation. At that time it was not known what form the litigation would take nor who would be defendants. The board of directors of American Factors, after consideration, authorized its president to secure counsel for American Factors to prepare for and conduct the defense in the threatened litigation. American Factors procured the services of prominent attorneys to represent it in the threatened litigation (R. 186, 254-255).

Prior to filing of the suits in the threatened Hackfeld litigation hereinafter more fully described, it was rumored that the 23 persons and corporations who had joined in the joint subscription agreement for shares of stock of American Factors were to be charged with fraud and conspiracy in connection with their participation in various capacities and various ways in the reorganization (R. 254-256). Under these circumstances, prior to the filing of any suit, 21 of the 23 (2 being dead) of those persons and corporations who had signed the joint subscription agreement entered into a written agreement dated July 28, 1924 (Ex. 1; R. 202-204), wherein they agreed to pro rate on an original per share basis the expenses of the aforesaid threatened litigation if they were joined as defendants therein. American Factors was not a party to the agreement of July 28, 1924 (R. 186-187).

The suit of J. C. Isenberg, et al., plaintiffs complainants, hereinafter called "Hackfeld plaintiffs" v. George Sherman . . . American Factors, Limited, et

al., defendants respondents, hereinafter called "Hackfeld defendants", and which litigation is herein called the "Hackfeld litigation", was commenced in August and September, 1924. Identical complaints in the Hackfeld litigation were filed in the Circuit Court of the First Judicial Circuit, Territory of Hawaii and in the Superior Court of the State of California in and for the City and County of San Francisco. By stipulation between the parties, the case filed in the California court was tried. American Factors was one of the defendants named in the Hackfeld litigation, and all of the 23 corporations and persons, including the representatives of the estates of the two deceased persons who had signed the joint subscription agreement, were joined as Hackfeld defendants (R. 187).

The Alien Property Custodian was made a respondent but no relief or judgment was sought against him. Certain other persons were made formal respondents alleging that they should have joined as plaintiffs (R. 188-189).

The Hackfeld litigation was brought in equity and the complaint in the action filed in California was entitled "Complaint for Accounting Relief Against Fraud and Conspiracy, for Damages and Incidental Relief." The gist of the complaint affirmed the sale and alleged that the sale and transfer were the result of conspiracy, collusion, and fraudulent connivance on the part of certain respondents whereby they secured the assets and profitable business of Hackfeld Company at a price far below its alleged intrinsic

value in fraud of and to the financial injury of complainants (R. 188). (J. C. Isenberg, et al., plaintiffs-complainants-appellants v. George Sherman . . . American Factors, Limited, et al., defendants-respondents-appellees, reported in 212 Cal. 454-461; 298 Pac. 1004 at 1005-1006.)

The object of the suit was to require respondents to account to complainants for the transfer and sale of the assets of Hackfeld Company to American Factors, Limited and to account for the difference between $7,500,000.00, the price at which the assets were sold and the actual value of the assets at the date of the transfer which was claimed to be $17,500,000.00 (R. 188).

The complaint, in paragraph XXXVI thereof, in substance alleged that American Factors, Limited took and received all of the assets of Hackfeld Company with full knowledge of all the facts and circumstances set forth in the complaint and with full knowledge of and concerning the rights and equities of said Hackfeld Company, and did thereafter handle the said assets and conduct the said business in trust for the protection by it of the rights and equities of said stockholders and the complainants and said American Factors did so mismanage said business and did so improperly handle said assets as to cause great damage to said assets and business and great injury to the rights and equities of complainants, and that American Factors was a party to the fraudulent scheme and the conspiracy therein alleged, and holds

tion which totaled $568,607.76 (R. 198, 260-261). The items of payment and the amounts thereof are shown in the tabulations in Ex. P-7 (R. 261-275).

During the early period of the Hackfeld litigation $396,812.50 of the litigation expenses were pro rated among 22 of the Hackfeld defendants who were charged with fraud and conspiracy in the litigation proportionately to their original stock subscriptions in American Factors, and these 22 Hackfeld defendants by about the end of the year 1925 or early January, 1926 paid to American Factors sums which totaled said sum of $396,812.50 on account of litigation expenses (R. 198-200). The question as to whether or not the Hackfeld defendants or American Factors would ultimately pay the expense of litigation was not then determined (R. 205, 280-283, 289).

The case went to trial and was on trial in the Superior Court of California at San Francisco for some 112 days of taking evidence. At its conclusion, the trial judge filed a terse memorandum as follows (R. 193):

> (Memorandum, January 6, 1926; *Isenberg v. Sherman,* 212 Cal. 454, 461; 298 Pac. 1004-1007.)
>
> "I am of the opinion that (1) no actual fraud on the part of respondents was shown; (2) no constructive fraud existed; (3) the price paid was adequate; (4) the suit is not barred by the Hawaiian statute of limitations; (5) plaintiffs were not guilty of laches. Frank J. Murasky, Judge." (R. 193.)

On March 16, 1926, a decision comprising Findings of Fact and Conclusions of Law was filed and on January 31, 1927 judgment was entered for the defendants and against the complainants (R. 193).

The Hackfeld plaintiffs perfected an appeal to the Supreme Court of the State of California where further hearings and arguments were had in the matter on appeal, and on April 30, 1931 the California Supreme Court rendered its opinion affirming the judgment of the trial court. This opinion is reported in 212 Cal. 454, 298 Pac. 1004. On May 28, 1931, the Supreme Court of California denied a petition for rehearing filed by Hackfeld plaintiffs. This opinion is reported in 212 Cal. 507; 299 Pac. 528. Thereafter, a motion to recall the remittitur issued to the County Clerk of San Francisco was filed by the complainants on August 26, 1931, and the Supreme Court of California in a decision handed down on January 29, 1932 denied plaintiffs' motion to recall the remittitur. (See 214 Cal. 722; 7 P. (2d) 1006.) On April 25, 1932 the Supreme Court of the United States denied a petition filed by the Hackfeld plaintiffs for a writ of certiorari to the Supreme Court of California, 286 U.S. 547 (R. 193-194).

Mr. Allen W. T. Bottomley reported to the stockholders of American Factors on the Hackfeld litigation at their annual meeting after the final decision of the California Supreme Court in 1932. He was at that time president of American Factors. He was joined as one of the defendants charged with fraud

in the suit and signed the agreement on July 28, 1924 (Ex. P-5, Ex. 1; R. 202-204). This exhibit shows that he had originally subscribed for 1,000 shares of stock of American Factors. He was a member of the steering committee named in Ex. P-5, Ex. 1 (R. 202-204, 256). As one of those charged with fraud and conspiracy, he had advanced sums which totaled $17,500.00 on account of legal expenses (R. 200). The records of that stockholders' meeting quote Mr. Bottomley as stating:

> "I should like to refer to the paragraph in my report which deals with the case of Isenberg et al. versus Sherman et al., or the so-called Hackfeld litigation, the expenses of which have been advanced by certain of the individual defendants pending the decision of the Court as to whether their acts were legal and the transaction a valid one. These defendants, as officers and large stockholders, participated in the organization of American Factors, Limited, and were made codefendants with American Factors, Limited in the litigation.
>
> "The litigation in California, as you all know, complained of the acts of these individual defendants, as well as the acts of American Factors, Limited, in connection with the reorganization of Hackfeld & Co. and the organization of American Factors, Limited, . . ." (Ex. P-5, Ex. 2; R. 205).

He further stated:

> ". . . that the defendants in the suit were attacked solely because they had assisted in the formation of American Factors, Limited. Accord-

ingly, I recommend to this meeting of Stockholders that they approve of the payment by the Company of the litigation expenses rather than have them remain as a charge against those who, under the direction of the Alien Property Custodian, were responsible for the formation of the Company.

"The Undivided Profits and Reserves of Hackfeld & Co. standing on the books of that Company as of August 18th, 1918, the date on which Hackfeld & Co. was taken over by the American Factors, Limited, were set aside as a reserve to meet any contingent claims on American Factors, Limited, or unknown liabilities of Hackfeld & Co., and I believe that the balance of this reserve could justly and properly now be used in the payment of these expenses so that the actual earnings of the Company would not be affected thereby." (R. 206.)

President Bottomley stated further that this matter was taken up with Mr. Oscar Sutro, attorney for the company during the litigation, and that he feels that the whole structure of the company was involved in the claims made by Mr. Nylen and that the litigation expenses should be paid by the company (R. 206).

After this report, on motion duly made and seconded, the stockholders adopted a resolution authorizing the corporation to pay all the costs and expenses of the Hackfeld litigation (excerpt from minutes R. 207). Pursuant to the authorization, the board of directors authorized the corporation to make the payment.

In the year 1932, after the conclusion of the Hackfeld litigation, American Factors repaid the said sum of $396,812.50 to the 22 stockholders (including the heirs of a deceased stockholder) who had been charged with fraud and conspiracy and who had contributed to the payment of such sum on account of the Hackfeld litigation expenses (R. 201).

The other approximately 614 original stockholders of American Factors, Limited paid no part of the Hackfeld litigation expenses (R. 185, 198-201). The trial court in the Hackfeld suit in its findings found that the 22 defendants charged with fraud and conspiracy did not reap any benefits from the reorganization or from the sale of stock of American Factors or the trust certificates therefor or from the purchase thereof by themselves, except such benefits as accrued to every purchaser of said trust certificates (R. 197).

In 1932, after the final conclusion of the Hackfeld litigation, all of the litigation expenses totaling $568,-607.76 were charged against the balance credit in the general reserve account of $541,237.79 which was carried over by American Factors from Hackfeld Company, which wiped out this reserve account, and the $27,369.97 necessary to make up the balance of the cost of litigation was charged against earned surplus (R. 289-291, 310).

THE HENRY WATERHOUSE TRUST COMPANY, LIMITED LOAN.

American Factors, at the end of the calendar year 1930, had a capital of $10,000,000.00 and its books showed a surplus and undivided profits of $5,971,-049.93, or a total capital and book surplus of $15,-971,049.93. At the end of the calendar year 1930, and during the entire calendar year 1931, American Factors was agent for thirteen sugar plantations and other corporations located in and carrying on business in the Hawaiian Islands, which corporations had a total capital of $26,944,720.00, a total surplus and undivided profits of $21,411,420.24, or a total capital and surplus as of December 31, 1930 of $48,356,140.24. On December 30, 1930, American Factors and the companies for which it served as agent had on deposit in the banks of the Territory of Hawaii at least a total sum of $1,741,696.24 (R. 376).

The Henry Waterhouse Trust Company, Limited, herein called "Waterhouse Company", was incorporated under the laws of the Territory of Hawaii on November 26, 1902, to engage in the business usual and permitted to a trust company under the laws of the Territory. In addition to usual fiduciary business common to trust companies, it operated a plantation agency department, a real estate department, a stock and bond brokerage department, and an insurance department and at times invested in stocks and bonds to a limited extent on its own account (R. 376-377).

In the middle of October, 1930, Waterhouse Company increased its capital stock from $200,000.00 to

$400,000.00 consisting of 4,000 shares of a par value of $100.00 each. The new shares were all taken by the old stockholders who paid for them in cash at par. In November, the effects of the general business depression began to be felt in the Territory, and as a large part of the Waterhouse Company assets consisted of real estate and mortgages, its secretary became apprehensive that if many calls were made on its demand accounts, the company's financial condition would not be sufficiently liquid to meet its cash requirements. He discussed the situation with the treasurer and auditor of the Waterhouse Company and advised the management of Bishop Trust Company, Limited, herein called "Bishop Trust" that a sale of the stock might be arranged, suggesting a price of $100.00 each or more for the shares (R. 377).

Late in November, 1930, Mr. Allen W. T. Bottomley who was president of American Factors and of Bishop First National Bank of Honolulu, and vice president and director of Bishop Trust called Mr. E. J. Greaney, an auditor, to his office and informed him that circumstances required that a confidential examination be made of the books and accounts of Waterhouse Company (R. 488). Mr. Bottomley informed Mr. Greaney that the balance sheet and statements of the Waterhouse Company indicated that the receivables or a substantial part of the assets were somewhat frozen and that if demand were made for payment of the large deposit accounts, the company would have difficulty meeting the demands because of the shortage of cash and the frozen condition of a substantial part of

the receivables (R. 489). Mr. Greaney was employed to make an audit under the circumstances. Mr. Greaney entered upon the work and as a part of it, together with others, from time to time made an exhaustive appraisal of the then value of the various types of receivables (R. 489-492, 499-500, 502-505).

Mr. Allen W. T. Bottomley called a conference of the heads of the three Hawaiian sugar agencies, the president of the Bank of Hawaii, Limited, the president of the Hawaiian Trust Company, Limited and two members of the finance committee of Bishop Trust to present to them the financial condition of the Waterhouse Company and discuss the feasibility of making some plan to prevent the Waterhouse Company from being forced into liquidation (R. 379).

The Waterhouse Company was conducting business as usual (at the end of 1930 and early in 1931), but was encountering some financial difficulties. Economic conditions were not clear, and after the investigation, the executives of Bishop Trust wished to look further into the matter before acting. After February 1, 1931, Bishop Trust advised Waterhouse Company shareholders that it would not pay cash for their shares (R. 380-382).

Mr. Greaney testified that a figure of $260,000.00 was added to the estimated losses determined in the appraisal referred to above (R. 496). He stated that this $260,000.00 represented a cushion in effect and had the effect of being a cushion to take care of any losses over and above the amount that was put in the loss

column on the schedule that was prepared covering the individual receivables that were on the books (R. 497-498).

He further stated that the loss estimate was increased by $260,000.00 when Bishop Trust refused to pay anything for the stock of Waterhouse Trust and that this was done "so that the reserve for contingencies was made to balance up so that it would appear proper to pay nothing for the stock" (R. 498).

An audit report dated March 31, 1931 signed H. C. Tennent and Co. by E. J. Greaney disclosed the book value of assets of the Waterhouse Company as of February 14, 1931, to be in the amount of $4,820,090.92, and the liabilities, exclusive of capital and surplus, to be in the amount of $4,149,437.06 (R. 377-378).

The audit report stated that the contingent reserve for losses of $680,803.15 and the special contingent reserve of $400,000.00 were considered adequate to cover probable losses in the realization of assets and liquidation of liabilities (R. 378).

On Saturday, February 14, 1939, the president of Bishop Trust at a meeting of the Board of Directors of that company made a statement which was recorded on the minutes (R. 380-382). The plan outlined in this statement in brief was that Bishop Trust would acquire the stock of Waterhouse Company without cost; for Mr. and Mrs. R. W. Shingle in settlement of their indebtedness to the company to pay to it $535,000.00 and to convey their respective 18% and 10% undivided interests in certain lands, the same to be sold for

$87,000.00 and the proceeds with $13,000.00 additional to be contributed by Bishop Trust to make up an even $100,000.00 to be paid into Waterhouse Company (R. 380-382).

In addition, a number of corporations and individuals were to loan various sums aggregating $400,000.00 and receive notes therefor (Ex. J; R. 410), thus making $1,035,000.00 of cash to be paid into Waterhouse Company. Bishop Trust was to pay such amount, if any, as might be required in addition to enable the Waterhouse Company to meet its liabilities, but it was hoped that no such contribution would be required. Bishop Trust was to take over, without other cost, the business of Waterhouse Company, other than assets and liabilities, and to operate such business at its own expense and for its own benefit, which included trusts, executorships, agencies, insurance, safe deposit business, etc., with the necessary furniture and equipment and supplies therefor (R. 380-382).

The plan was that the assets and liabilities were to be liquidated by applying the assets to the liabilities and in final settlement, if there was an excess of assets over liabilities, it was to be applied first to the reimbursement of the amount contributed by Bishop Trust, if any, in addition to the $1,035,000.00 and secondly, pro rata to the lenders of the $400,000.00 with interest at 4% and thirdly the balance, if any, to go to Bishop Trust Company, Limited (R. 382).

American Factors and each of the persons lending money to the trust company under this agreement received notes which were identical in form. A true

copy of the note delivered to American Factors is shown in Ex. J (R. 410).

Letters showing the basis of the borrowings are shown as Exs. H and I (R. 402-409).

Sherwood M. Lowrey, the treasurer of American Factors, testified that he had conferred with Mr. Bottomley, the president, about the loan at the time it was made, and that Bottomley stated that it was to the best interests of the community and of American Factors to make the loan, and that "if the money was so loaned, there is a perfectly reasonable chance of getting the money back" (R. 473-474). The note (Ex. J., R. 410) was set up on the books of American Factors as a perfectly good asset (R. 474).

Mr. A. L. Castle who was a stockholder of Waterhouse Company (R. 507) testified that he thought the loan to Waterhouse Company was a good loan (R. 511) and that his father made the loan.

Mr. Arthur L. Dean testified on behalf of one of the lenders, Alexander and Baldwin, Limited, that at the time the loan to Waterhouse Company was made, they expected to get all or part of the money back again, but the stake in preserving the company was sufficiently large so that they were prepared to make the loan (R. 532).

The Bank Examiner's report which was made as at December 31, 1932, stated that:

> "The records of the Henry Waterhouse Trust Company, Limited, show that subsequent to February 14, 1931, and shortly after the company was taken over by the Bishop Trust Company,

> Limited, sufficient assets appeared to be on hand to meet all liabilities of the company. . . ." (R. 554).

An advisory committee of the lenders was appointed to pass upon the program of liquidation and the members of the advisory committee are shown at R. 388-389.

Mr. S. M. Lowrey, plaintiff's treasurer, was alternate member for Mr. Bottomley. This committee met frequently with the financial committee of the Waterhouse Company and passed upon all matters of importance, and particularly those matters tending to affect the amount of reimbursement, if any, ultimately to be made to the special note holders (R. 390).

Under date of July 18, 1932, Waterhouse Company, over the signature of M. B. Henshaw, dispatched to the plaintiff a letter (a true copy of which marked Ex. M is shown at R. 413-414) stating that early in 1932, the advisory and finance committee of Waterhouse Company decided that it was advisable to reappraise the assets and that an exhaustive reappraisal disclosed that its liabilities other than those to the lenders and stockholders exceeded the value of the assets by a very considerable amount, and advised them that the note had now become worthless (R. 413-414).

S. M. Lowrey, the then treasurer of American Factors, testified that he reviewed the note again at the end of the calendar year 1931 and that he considered that it was a good note at that time and no reserve was created (R. 466). It was a part of his duties as treasurer to review each year all the receivables and reap-

praise them (R. 466-467). He had seen the letter of July 18, 1932 referred to hereinabove, that he was on the advisory committee as Mr. Bottomley's alternate and he knew what procedure that committee followed in determining the value of the assets, and that after receiving the letter, he went into the thing more thoroughly than ever before and consulted with Mr. Henshaw and Mr. Linden of Alexander and Baldwin; that he went into the question of the assets that remained to be liquidated (R. 468). He came to the conclusion by the end of the year 1932 that the note was valueless and in order to get a proper balance sheet, he wrote it off and also claimed it as a tax deduction (R. 468).

The Bank Examiner of the Territory of Hawaii completed an examination of the condition and affairs of Waterhouse Company as at December 31, 1932, and stated of the company's condition as at that time: "An analysis of the various asset and liability accounts of the company made by us as at December 31, 1932, disclosed, according to our figures, an insufficient amount of assets to meet the remaining liabilities." (R. 554).

The third paragraph of the Bank Examiner's report states that contingent reserve and capital are entirely absorbed and that Bishop Trust Company, Limited, advances to an amount of $255,215.61 were used to meet estimated losses (R. 554-555). In brief, the Bank Examiner's report after revaluing assets as at December 31, 1932, showed the notes of the corporations and persons who loaned Waterhouse Company $400,000.00 were valueless as at December 31, 1932.

QUESTIONS OF LAW INVOLVED.

(1) Is American Factors entitled to a deduction of $396,812.50 of Hackfeld litigation expenses, reimbursed to its co-defendants in the year 1932, as an ordinary and necessary expense of carrying on its business, in the computation of its federal income tax liability for the year 1932?

(2) Is American Factors entitled to a deduction of the amount of $50,000.00, advanced by it to Waterhouse Company and charged off as worthless in the year 1932, as a bad debt, as an ordinary or necessary expense of carrying on its business, or as a loss sustained in the year 1932, in the computation of its federal income tax liability for the year 1932?

SPECIFICATION OF ERRORS RELIED ON.

The United States District Court for the Territory of Hawaii erred:

(1) In concluding that American Factors is entitled to a deduction of only $171,795.26 instead of $568,607.76 of the Hackfeld litigation expenses as ordinary and necessary expenses paid or incurred during the taxable year 1932;

(2) In concluding that $396,812.50 of the Hackfeld litigation expenses, which American Factors refunded or repaid in the year 1932 to persons and corporations who were co-defendants with American Factors in said litigation, were not ordinary or necessary expenses paid or incurred during the year 1932;

(3) In failing to find and hold that the Commissioner of Internal Revenue erred in disallowing American Factors a deduction of $568,607.76 of the Hackfeld litigation expenses in computing its net taxable income for the year 1932;

(4) In concluding that there was no legal obligation or liability on the part of American Factors to reimburse or refund to its stockholders who were co-defendants with it in the Hackfeld litigation, the sum of $396,812.50 which American Factors repaid to them in 1932;

(5) In failing to find and hold that even in the absence of any legal obligation or liability on the part of American Factors to reimburse or refund to its stockholders who were co-defendants with it in the Hackfeld litigation, the refund or repayment to them was nevertheless an ordinary and necessary expense of American Factors paid or incurred during the year 1932;

(6) In concluding that the payment of $50,000.00 to Waterhouse Company in 1931, by American Factors, was just a contribution;

(7) In concluding that the note given by Waterhouse Company, in 1931, to American Factors, was contingent in payment; was subject to such conditions as to render it nonnegotiable, and was without any negotiable value at the time it was made and at all times thereafter;

(8) In concluding that the note given by Waterhouse Company, in 1931, to American Factors, could not be dealt with as a debt;

(9) In concluding that the contingencies as to payment and/or the lack of negotiable value prevented said note from being evidence of a debt;

(10) In concluding that the Commissioner of Internal Revenue did not err in disallowing American Factors a deduction therefor as a bad debt in computing its taxable net income for the calendar year 1932;

(11) In concluding that no part of the payment of $50,000.00 made to Waterhouse Company in 1931 by American Factors was deductible as a bad debt ascertained to be worthless and charged off within the tax year 1932, or as a loss sustained during that taxable year;

(12) In failing to render judgment in favor of American Factors for the amount of $97,134.90 instead of the amount of $31,691.18 on account of American Factors' overpayment of income tax for the year 1932.

SUMMARY OF ARGUMENT.

I.

THE COURT ERRED IN DISALLOWING THE DEDUCTION BY AMERICAN FACTORS OF $396,812.50 OF HACKFELD LITIGATION EXPENSES REIMBURSED TO OTHER DEFENDANTS AS AN ORDINARY AND NECESSARY EXPENSE IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

The court correctly held that the full amount of the Hackfeld litigation expense is an ordinary and neces-

sary business expense, all of which accrued for income tax purposes in the year 1932, but erred in holding that American Factors cannot deduct the portion thereof which it reimbursed to the co-defendants in that litigation.

(A) The co-defendants in the Hackfeld litigation did not voluntarily pay the expense of litigation without expectation of reimbursement in the event that they were freed of charges of fraud and conspiracy upon the final determination of the litigation.

The court erred in holding that the co-defendants in the Hackfeld litigation voluntarily paid the expense of litigation without expectation of reimbursement or demand therefor after successful determination of the litigation in 1932. Actually, the agreement among the co-defendants was that among themselves they would pay their pro rata share of the litigation expense on the basis of original shareholdings, but, as between the group of co-defendants and American Factors, the determination as to which was to bear the ultimate expense of litigation was dependent on the final determination of the litigation. Even in the absence of any agreement, if the co-defendants were finally adjudged guilty of fraud or conspiracy, they, and not American Factors, would have been liable for the costs of litigation. In addition, a request for reimbursement was made on behalf of the co-defendants.

(B) Once the litigation charging the co-defendants with fraud and conspiracy had been finally concluded holding that they were not guilty of any fraud or conspiracy, then American Factors for the first time became bound to pay the litigation expenses and to reimburse the co-defendants for the expenses paid by them which amounted to $396,812.50.

Upon the successful termination of the litigation in 1932 holding that the co-defendants were not guilty of fraud or conspiracy, there was created an absolute legal liability of American Factors for the payment of all the litigation expense. This liability arose by the conferring of benefits on the corporation by this group of co-defendants for the benefit of American Factors, thereby setting up a right of reimbursement out of the fund protected. Also, the liability arose under the doctrine of restitution, and is founded as well on the law of agency. Further, even if there were only a moral obligation on American Factors to reimburse its co-defendants, that would be sufficient to entitle American Factors to the deduction of the amounts paid as ordinary and necessary expenses.

II.

THE COURT ERRED IN DISALLOWING AMERICAN FACTORS THE DEDUCTION OF THE PAYMENT OF $50,000.00 TO WATERHOUSE COMPANY IN 1931 IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

(A) The sum of $50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a bad debt, determined to be worthless and charged off within the tax year 1932.

American Factors did not intend to make a gift or contribution to Waterhouse Company. The money

advanced constituted a loan which was to be repaid from the liquidation of the assets of Waterhouse Company, and there was full expectation that the note would be repaid. It was only when business conditions in the community took an unexpected turn for the worse that the note was ascertained to be worthless and charged off.

(B) If not deductible as a bad debt, the sum of $50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a loss sustained, or as an ordinary and necessary expense of American Factors in 1932.

Despite the court's holding, there was evidence that American Factors would incur a loss if Waterhouse Company were allowed to fail. In addition to the direct evidence, the court may take judicial notice of the precarious condition of financial institutions all over the country at the time, and may consider the statement of the Tax Court in previously reported opinions relating to the same transactions.

ARGUMENT.

I.

THE COURT ERRED IN DISALLOWING THE DEDUCTION BY AMERICAN FACTORS OF $396,812.50 OF HACKFELD LITIGATION EXPENSES REIMBURSED TO OTHER DEFENDANTS AS AN ORDINARY AND NECESSARY EXPENSE IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

Section 23 of the Revenue Act of 1932 providing for the deduction of ordinary and necessary expenses of corporations is as follows:

"Sec. 23. Deductions From Gross Income.

"In computing net income there shall be allowed as deductions:

"(a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."

The Hackfeld litigation, while in equity, claimed damages for fraud and conspiracy of the directors and stockholders who had participated in the reorganization of Hackfeld Company into American Factors. It affirmed the sale and transfer of the assets of Hackfeld Company and alleged that the sale and transfer (of said assets and businesses) were the result of conspiracy, collusion and fraudulent connivance on the part of the defendants whereby they caused to be sold to American Factors at a price far below its alleged intrinsic value these assets (R. 72).

Every act done which petitioners in the Hackfeld litigation contend was fraudulent or conspiratorial was done in and about and pertaining to this reorganization (R. 72).

If these persons and corporations (hereinafter called the "co-defendants") were found guilty of fraud and conspiracy as between themselves and American Factors, the obligation to pay all litigation expenses as well as the damages assessed was theirs rather than American Factors'. Had the co-defendants been held guilty of fraud and conspiracy in the reorganization of Hackfeld Company into American Factors as between American Factors and these co-

defendants charged, American Factors would have a good cause of action against them for all of the damages caused by their tortuous acts. *Blackwell Oil & Gas Co. v. Commissioner of Internal Revenue,* 60 F. (2d) 257.

In June, 1924, when the directors of American Factors were informed that the former stockholders of Hackfeld Company threatened to initiate litigation, although it was not known what form the litigation would take, nor who would be the co-defendants, American Factors engaged the services of attorneys to represent it in the threatened litigation and to prepare for and conduct the defense (R. 186). Before the suits were filed, twenty-one of the twenty-three persons and corporations (two having died) who had joined in the joint subscription for the shares of stock of American Factors at the time of its organization, entered into a written agreement, to which American Factors was not a party, wherein they agreed to prorate, on an original per share basis, the expenses of litigation if they were joined as co-defendants therein (R. 186-187).

When the suits were started, all twenty-one living, and the estates of the two who had died, of those who had signed the original joint subscription agreement were joined as co-defendants (R. 187). American Factors paid from time to time all the expenses of the Hackfeld litigation, which totaled $568,607.76, which payments were carried on its records as deferred items. During the earlier period of the litigation $396,812.50 of the above expenses was prorated

among twenty-two of the co-defendants in accordance with the agreement, and American Factors collected that amount from them (R. 198-200). This method of handling the litigation expense was in accordance with the instructions given by the president of American Factors to the treasurer, namely, to keep track of all expenses paid; that the group of co-defendants were to be billed an amount to cover their pro rata shares; that the account was to be carried in this manner and eventually it would be decided, after the suit had been determined, as to who would ultimately bear the expense of the litigation (R. 280). The determination as to who would ultimately bear the expense depended on whether the court determined whether the acts of the individual co-defendants were legal and the transactions were valid. These defendants were officers and large stockholders who participated in the organization of American Factors and who were attacked solely because they assisted in the formation of American Factors (R. 205-206).

The Hackfeld litigation was concluded in 1932 (R. 60, 77, 78) making final the determination of the trial court that there was no actual or constructive fraud and that the transactions involving the organization of American Factors and its purchase of the business of Hackfeld Company was a valid one, and with the finding that none of the co-defendants reaped any benefit from said reorganization or the sale of stock of American Factors or the purchase thereof by themselves, except such benefits as accrued to every purchaser of said certificates (R. 75, 77).

The co-defendants having been freed of any claim of fraud, A. W. T. Bottomley, one of the co-defendants, sought the opinion of attorney Oscar Sutro as to whether American Factors should pay the litigation expense. It was the opinion of said counsel that American Factors should pay all of the litigation expenses (R. 206). Other counsel, who had been asked only the questions whether the payment would be *ultra vires* and if American Factors was morally obligated to pay said expenses, advised that it was within the power of the corporation to reimburse the expenses paid by other co-defendants and that the corporation is under moral obligation to make such reimbursement (R. 206-207; Ex. P-10, R. 347, 355).

Mr. Bottomley, president of American Factors, who was one of the members of the steering committee and the owner of 1,000 shares, and who had paid in $17,500.00 of the litigation expenses as his pro rata share, stated, at the annual meeting of stockholders held in March, 1932 that the expenses of the Hackfeld litigation had been advanced by certain of the individual co-defendants pending the decision of the court as to whether their acts were legal and the transaction a valid one; that these co-defendants as officers and large stockholders participated in the organization of American Factors and were made co-defendants with American Factors in the litigation (R. 205), and that the co-defendants in the suit were attacked solely because they had assisted in the formation of American Factors, and he recommended that the meeting of stockholders approve of the payment of

the litigation expenses (R. 206), and upon resolution duly adopted, the stockholders unanimously voted that the co-defendants be reimbursed the amount advanced by them (R. 207).

The gist of the holding of the court with relation to the portion of the Hackfeld litigation expenses reimbursed to the co-defendants as set out in the decision (R. 62-64), the opinion (R. 59-60), the findings of fact (R. 67-79) and the conclusions of law (R. 100-102), is that although the full amount of the litigation expense is an ordinary and necessary expense, all of which accrued for income tax purposes in the year 1932, nevertheless, American Factors is not the person entitled to the deduction therefor. (R. 59-60, 62-64, 77-79, 100-102).

The determination of the court that the Hackfeld litigation expenses are ordinary and necessary business expenses is fully supported by the authorities. *Commissioner of Internal Revenue v. Heininger,* 320 U.S. 467, 88 L. ed. 171; *Welch v. Helvering,* 290 U.S. 111, 78 L. ed. 212; *Kornhauser v. United States,* 276 U.S. 145, 72 L. ed. 505; *Rassenfoss v. Commissioner of Internal Revenue,* 158 F. (2d) 764.

That the court correctly ruled that all the litigation expenses accrued in 1932, regardless of the time of payment, is also in accord with the authorities, it being well settled that a liability does not accrue until all the events occur that fix the amount and the fact of liability. *Dixie Pine Prod. Co. v. Commissioner of Internal Revenue,* 320 U.S. 516, 88 L. ed. 270;

Security Flour Mills Co. v. Commissioner of Internal Revenue, 321 U.S. 281, 88 L. ed. 725; *Baltimore & Ohio R. Co. v. Magruder,* 174 F. (2d) 896.

This conclusion is based on the facts stated by the court that the co-defendants, other than American Factors, entered into an agreement among themselves to pay pro rata on the basis of the stock for which they originally subscribed, the litigation costs of the suit (R. 60), that the persons who subscribed to pay voluntarily for the defense were motivated by personal interests and desires to clear themselves as defendants against claims that they had unlawfully conspired and acted in fraud and for the purpose of escaping a liability in damages by a possible judgment against them and to protect their individual investments as stockholders in the corporation (R. 62); that they made the payments without promise or original expectation of reimbursement at the time of the contribution; that they made no demand or test of their right to be reimbursed for the expenses paid; that the act of American Factors in reimbursing them flowed from feelings of gratitude, and the liberal aid of the contributors and their steering committee contributed many facilities and influences such as could not have been supplied by the management of American Factors acting alone (R. 62, 65, 77-79).

However, the court did hold that American Factors had very substantial interests to protect and was justified in every way, as a legitimate business outlay, in paying from its own funds during the tax year

1932, or earlier years had it chosen to do so, the costs of litigation which imperiled its existence, although others were involved in the same litigation as defendants and had much to lose (R. 63, 79), that it was only because others had come forward with the funds and volunteered to engineer and fight the battle at their own cost that American Factors was not justified in deducting from its taxable income the money it paid to reimburse those who contributed the money for the defense of the litigation even though the victory brought great benefit to American Factors as well as the co-defendants (R. 63-64, 79).

The court further found that it had been established in the Hackfeld litigation that the co-defendants did not reap any benefit from the reorganization or from the sale of the stock of American Factors or from the purchase thereof by themselves, except such benefits as accrued to every purchaser of the stock (R. 77). There were 615 other original stockholders who were not made co-defendants in the Hackfeld litigation who paid nothing into the litigation fund (R. 60).

From the holdings of the court, it became apparent that the court erred in holding that American Factors could not reimburse the co-defendants for the amounts advanced by them as litigation expense and deduct the same as litigation expense in the year in which the litigation was concluded and the liability for the expenditure of the litigation expense became certain.

The court, in finding that there was a voluntary payment by the co-defendants, appears to have misconstrued the agreement among them. All of the co-defendants were in the same position, and as the court found, were only made co-defendants because they actively participated in the transactions out of which American Factors was organized. As such, their only benefits were by reason of their participation and could be measured pro rata according to the number of shares of American Factors which they acquired. Accordingly, they agreed among themselves that if joined as defendants, they would share the costs pro rata according to the number of shares of stock subscribed for and issued to each, and that is the sole purpose of their agreement. As between them, as a group, and American Factors, there was no agreement at that time as to who was ultimately to bear the expenses, but, as stated by A. W. T. Bottomley, who was one of the co-defendants and a member of the steering committee, the question as to whether American Factors or the co-defendants were to bear the litigation cost was one that was left to be determined after the case had been decided and a determination made by the court as to whether the co-defendants were or were not guilty of fraud and conspiracy.

It is the contention of American Factors that, first, there was no voluntary payment of litigation expenses by the co-defendants, but merely machinery set up under which those persons who performed the very acts for which the co-defendants and American Factors were being sued would share the litigation ex-

pense in an equitable manner among themselves until it was determined that they were not guilty of any fraud or conspiracy; second, once it had been determined that the persons acting on behalf of American Factors were not guilty of fraud and conspiracy, as between them as a group and American Factors, American Factors was bound to pay all the litigation expenses and to reimburse the amounts advanced by these co-defendants.

(A) The co-defendants in the Hackfeld litigation did not voluntarily pay the expense of litigation without expectation of reimbursement in the event that they were freed of charges of fraud and conspiracy upon the final determination of the litigation.

As pointed out above, the co-defendants agreed among themselves that, until such time as they were cleared of fraud and conspiracy, they would pay the costs pro rata, according to the number of shares of stock subscribed for and issued to each. As far as American Factors was concerned, no agreement was made with it, but its role was to act as the banker for the group of co-defendants; to pay the costs in the first instance with the approval of the steering committee, to keep record of such expenses with the determination as to who was to ultimately bear the costs of the litigation dependent upon the final determination of the litigation.

In 1932, the year in which the Hackfeld litigation was finally determined, A. W. T. Bottomley, who was a member of the steering committee, who had been an original subscriber for shares of stock, and who

had paid $17,500.00 toward the cost of the litigation expenses, stated the gist of the understanding between American Factors and the co-defendants and requested and strongly recommended the reimbursement of the litigation expenses to the co-defendants.

He also stated that he had received the opinion of Oscar Sutro, the principal counsel for the co-defendants, that under the circumstances of this litigation, American Factors was liable for the payment of the costs thereof.

Furthermore, until it had been determined that the co-defendants were not guilty of fraud and conspiracy, American Factors was under a duty not to pay the litigation expenses incurred in defense of the suit.

It is clearly settled law that if the co-defendants had been guilty of fraud, even in actions purporting to be for the benefit of American Factors, such defendants, and not American Factors, would have been obligated to pay the entire costs of the litigation. In *Blackwell Oil & Gas Co. v. Commissioner of Internal Revenue,* 60 F. (2d) 257, the taxpayer claimed the deduction, as a business expense, of an amount which it had paid in settlement of a suit which was predicated upon an alleged conspiracy entered into between the defendants in the action as directors of the corporation. The court stated at page 258:

> ". . . The defendants in the action, as directors of the corporation, *had no authority to enter into any unlawful conspiracy.*[1] While the alleged acts

[1]Emphasis supplied.

committed in furtherance of the conspiracy were largely acts committed by the defendants as officers and directors of the corporation, the gist of the action was a conspiracy. It seems clear to us that the *petitioner was not liable for the cause of action compromised and the amount paid in compromise was neither an ordinary or necessary expense of the corporation . . .*"[1]

If the court had held in the Hackfeld case that the officers and stockholders of the corporation, who had acted as agents and officers in performing the acts complained of, had been guilty of performing fraudulent and improper acts, these co-defendants would not, as agents, officers or directors or otherwise, have had any authority from American Factors to enter into such conspiracy to defraud or to perform the fraudulent acts complained of. Upon such a holding, American Factors would disavow any liability for the other co-defendants' acts and would not, as between itself and the other co-defendants, be legally liable for the expenses of defending the litigation.

(B) Once the litigation charging the co-defendants with fraud and conspiracy had been finally concluded holding that they were not guilty of any fraud or conspiracy, then American Factors for the first time became bound to pay the litigation expenses and to reimburse the co-defendants for the expenses paid by them which amounted to $396,812.50.

As the court finally determined that there was no fraud and no conspiracy, and as all acts complained of were for the benefit of and done in connection with American Factors' business, there was an absolute legal liability upon American Factors to pay all of

the costs of defending such litigation. A corporation is liable for and may employ its funds in the defense of legal proceedings even though brought against the officers or members of its committees, etc., where it has an interest in and is affected by the litigation. See *Fletcher Cyclopedia Corporations, Permanent Edition,* Sec. 2507.

That this is so, the court recognized in its holding in effect that the litigation expenses were ordinary and necessary business expenses and would have been deductible at the final conclusion of the litigation if they had not been voluntarily paid by the co-defendants.

In *Mitchell v. Beachy,* 110 Kans. 60, 202 Pac. 628, it was held that a corporation had a duty to keep its stock records straight and accurate and, consequently, it could lawfully pay and had a legal obligation to pay all of the attorneys' fees for defending a suit brought against the cashier of the bank personally, and also the bank, in which such matter was involved. In that case, as in the present one, there were other parties than the defending corporation, and the decision of the court sustained as proper the payment of the whole fee for the defense of all parties named as defendants in the suit.

In the present case, the final determination as to who was legally obligated for the payment of the expense of the litigation, as between the co-defendants and American Factors, could not be made until the litigation itself was terminated, which was in 1932, at

which time, for the first time, it was definitely determined that American Factors was legally obligated to pay all the expenses of litigation, and this is true even though the other co-defendants were joined in the litigation.

It is also a well-established rule that any one person or persons who, having an interest in a trust fund (or having an interest in a corporation) at his or their own expense takes proper proceedings to save the funds from destuction or to restore the funds, is entitled to reimbursement either out of the fund itself or from proportional contribution from those who accept the benefit of his efforts. *Trustees of the Internal Improvement Fund v. Greenough,* 105 U.S. 527, 26 L. ed. 1157; *Sprague v. Ticonic National Bank,* 307 U.S. 161, 83 L. ed. 1184. This is an old established rule of chancery under which all the persons who benefit bear the expenses incurred in obtaining or preserving the benefit for the common good.

In the present case, only twenty-three of the stockholders who originally owned one-half of the stock of American Factors were named as co-defendants in the Hackfeld litigation. There were 615 other stockholders who originally acquired the other one-half of the shares of American Factors. Upon final determination in 1932, that the co-defendants were not guilty of fraud or conspiracy, the benefit to American Factors and to the large number of shareholders owning the other stock of American Factors that accrued by reason of the successful defense of the Hackfeld liti-

gation by the co-defendants, created a liability in American Factors, either in law or in equity, to pay out of the corporate funds preserved in said Hackfeld litigation to these co-defendants the amount they had advanced on account of the Hackfeld litigation expenses.

Further, it is clear that American Factors, having received a great benefit from the services of the co-defendants by their defense in the Hackfeld litigation and their advance collectively of $396,812.50 of the Hackfeld litigation expense, was bound to reimburse them for these costs under the Doctrine of Restitution. See *Restatement of the Law, Restitution:*

> "Sec. 1. UNJUST ENRICHMENT.
>
> *"A person who has been unjustly enriched at the expense of another is required to make restitution to the other.*
>
> *'Comment:*
>
> *"a.* A person is enriched if he has received a benefit (see Comment *b).* A person is unjustly enriched if the retention of the benefit would be unjust (see Comment *c).* A person obtains restitution when he is restored to the position he formerly occupied either by the return of something which he formerly had or by the receipt of its equivalent in money. . . .
>
> *"b. What constitutes a benefit.* . . . He confers a benefit not only where he adds to the property of another, but also where he saves the other from expense or loss. The word 'benefit,' therefore, denotes any form of advantage. . . .

"*c. Unjust retention of benefit.* Even where a person has received a benefit from another, he is liable to pay therefor only if the circumstances of its receipt or retention are such that, as between the two persons, it is unjust for him to retain it. . . . The Restatement of this Subject states the rules by which it is determined whether or not it is considered to be just to require restitution." (pp. 12-13.)

Further, it cannot be said that the co-defendants acted officiously in paying the litigation expenses. *Sec. 2 of Restatement of the Law, Restitution,* is as follows:

"Sec. 2. Officious Conferring of a Benefit.

"*A person who officiously confers a benefit upon another is not entitled to restitution therefor.*

"*Comment:*

"*a.* Officiousness means interference in the affairs of others not justified by the circumstances under which the interference takes place. Policy ordinarily requires that a person who has conferred a benefit either by way of giving another services or by adding to the value of his land or by paying his debt or even by transferring property to him should not be permitted to require the other to pay therefor, unless the one conferring the benefit had a valid reason for so doing. . . ." (pp. 15-16).

Section 4 deals with the remedy and under (f) it shows that one of the remedies for the recovery of the benefit is by judgment at law or decree in equity for the payment of money.

In *Topic 3,* the subject of restitution deals with discharge by one person of a duty also owed by another. This is as follows:

"Topic 3. Discharge By One Person Of Duty Also Owed By Another.

"*Introductory Note:* This Topic deals primarily with situations in which two or more persons were subject to a contractual, quasi-contractual, or other duty which is discharged in whole or in part by one of them, although the other was subject to a duty of performance either prior to, or together with, the one who discharges it. It also deals with situations where, at the time of the discharge, one of the parties is not subject to the duty, including cases where payment is made in the erroneous belief that such a duty exists.

"The situations dealt with in this Topic include those where there are contractual relations between the parties as well as those where there are no such relations.

"Ordinarily, where, at the request of another, a person performs duties owed by the other, acts for the other, or assumes duties owed primarily by the other, it is upon the implicit assumption that he is to be indemnified by the other for payments properly made by him in the course of the transaction. Even if the parties do not have in mind the necessity of such indemnity or do not think of it in detail, a duty of indemnity will be imposed upon the other unless there is an agreement to the contrary. So, too, where two persons engage in a common undertaking or where, to the knowledge of both, two persons become sureties for a third,

an agreement for mutual contribution for expenses borne by each will ordinarily be inferred from the circumstances; *unless the parties agree otherwise, such a duty will be imposed upon them as is consistent with what would have been a fair agreement between them had they considered the matter.*[1] . . .

"Likewise, by a breach of duty to another, a person may cause the other to be liable in tort to a third person, as where a servant is negligent, causing both himself and his master to be liable. In such case, if the other pays the damages thereby relieving the tort-feasor from liability, there is a right to restitution which may exceed the amount of benefit derived from the payment, as where expenses of suit are paid.

". . . Whether or not the duty is based upon a contract or a tort or is quasi-contractual in nature, at common law an action would lie on the common counts for a payment which benefited the person who should have paid in whole or in part, and in practice today the form of remedy does not depend upon an analysis of the basis of restitution, except where recovery is sought for more than the amount of benefit conferred." (pp. 327-329.)

The principles enunciated in the Restatement of the Law of Agency, although on a different basis, substantiate American Factors' claim in this particular.

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[1]Emphasis supplied.

The law of Agency also furnishes an analogous conclusion. *Williston on Contracts,* Revised Edition, Vol. Four, Section 1026 is as follows:

> *"Employee's right to exoneration, indemnity, and reimbursement.*
>
> ". . . It would seem, furthermore, that a servant or agent should be reimbused for expenses of defending actions by third persons brought because of the agent's authorized conduct, especially where such actions are unfounded even though not brought in bad faith. For the same reason an agent or employee is entitled to this protection against liability to third persons arising from the performance of the employment."

Restatement of the Law—Agency, Section 439, is in part as follows:

> "439. When Duty of Indemnity Exists.
>
> *"Unless otherwise agreed, the principal is subject to a duty to an agent, not barred by the illegality of his conduct, to reimburse him for or to exonerate him from:*
>
> . . . . . .
>
> "(d) *expenses of defending actions by third persons brought because of the agent's authorized conduct, such actions being unfounded but not brought in bad faith; . . .*"

See, also, *Solimine v. Hollander,* 129 N.J. Eq. 264, 19 Atl. (2d) 344, where it is stated:

> "Where directors of corporation successfully defended stockholder's derivative suit in which an accounting was sought against directors be-

cause of alleged dereliction of duty, the directors were entitled to indemnification or reimbursement from the corporation for the reasonable necessary expenses and counsel fees incurred by them in defending the suit, . . ."

New York Dock Co. v. McCollom, 16 N.Y.S. (2d) 844.

Headnote 1 in this case is as follows:

"1. *Costs.*

"Ordinarily, the successful party in litigation is not reimbursed for his counsel fees or other expenditures, but when a party to a litigation creates, increases, or protects a fund or property for the benefit of a class, he is ordinarily entitled to have his lawyers compensated and similar expenses paid from the fund or property."

This case is direct authority that when a party to litigation undergoes the expense to protect a fund or property which results in a benefit to all, he is ordinarily entitled to have his legal expenses paid from the fund or property. This case and foregoing authorities are direct authorities to the effect that had American Factors been sued for reimbursement of litigation expenses advanced by the co-defendants, the courts must give them a judgment for the full amount of their payments.

The court found that the services of the steering committee and the co-defendants were of great value to American Factors in the successful defense of the

Hackfeld litigation and were of a nature which American Factors could not otherwise have furnished for itself (R. 63). This finding would seem to establish the legal right of the co-defendants to restitution for the costs of the litigation which they furnished, even if these costs had been paid voluntarily as the court found, and even though there had been no understanding that they would be reimbursed if they were cleared of the charges of fraud and conspiracy.

Finally, in any event, the fact that a moral obligation existed to reimburse said co-defendants would be sufficient to sustain the deductibility of the amounts reimbursed to the co-defendants.

In *Dunn & McCarthy v. Commissioner of Internal Revenue,* 139 F. (2d) 242, there was in question the deduction of payments made by the corporation as ordinary and necessary expenses. The amounts in question were repaid to salesmen of the company for loans made to the president of the company who had committed suicide and whose estate was insolvent. The purpose was to protect the good will of the business. The court held that there was no legal obligation to repay said loans, but the moral obligation was recognized. The salesmen, in lending money, were undoubtedly influenced by the official position of the president. The failure of the corporation to recognize the loans would impair the attitude of the salesmen as well as affect customers adversely. Accordingly, such payments were held to be ordinary and necessary expenses deductible by the corporation.

Here the reimbursement to the co-defendants of the litigation expenses paid by them, even if founded only upon a moral obligation, would be deductible as ordinary and necessary expenses by American Factors.

It is respectfully submitted that on the foregoing authorities, upon the conclusion of the Hackfeld litigation in the calendar year 1932, American Factors became and was liable for the first time to pay all of the expenses of the Hackfeld litigation. That such payment was an ordinary and necessary expense of the business and deductible as such in that year.

II.

THE COURT ERRED IN DISALLOWING AMERICAN FACTORS THE DEDUCTION OF THE PAYMENT OF $50,000.00 TO WATERHOUSE COMPANY IN 1931 IN COMPUTING ITS TAXABLE NET INCOME FOR THE CALENDAR YEAR 1932.

The note of Waterhouse Company (Ex. J, R. 410), evidencing a payment by American Factors of $50,000.00 in 1931, which American Factors ascertained to have become uncollectible in 1932 (R. 468-470) and which it charged off in that year and deducted as a bad debt loss in computing its taxable net income for the calendar year 1932 (R. 394-395), was given to American Factors under the following circumstances:

Waterhouse Company, which was incorporated as a trust company, found itself short of liquid capital and, in October, 1930, increased its capital stock from

$200,000.00 to $400,000.00 by the sale of additional stock to the old stockholders for cash (R. 376-377). Within a month thereafter it became apparent that the general business depression was being felt in the Territory, and the officers were concerned as to whether the company's financial condition was sufficiently liquid to enable it to meet its cash requirements. As a result of discussions among the officers and directors of the company, negotiations were entered into with Bishop Trust Company, Limited, for the sale to it of the stock of Waterhouse Company (R. 377). A detailed examination and appraisal was made of the assets and liabilities of Waterhouse Company (R. 377-379, 488-492, 499-500, 502-505), as a result of which a plan was agreed upon under which two officers, who were large debtors of the company, were to settle their indebtedness to Waterhouse Company, and certain corporations and individuals were to lend various sums to make up a fund aggregating $400,000.00 (R. 379-382). Upon these conditions being met, Bishop Trust Company, Limited, agreed to take over the stock and operate the business of Waterhouse Company, to liquidate its assets and liabilities, and to return any excess of assets over liabilities to the contributors to said fund after reimbursing itself for any additional amounts that it might be required to advance (R. 377-384, 402-409).

American Factors advanced the sum of $50,000.00 to said fund and received a note (Ex. J; R. 410), under the terms of which Waterhouse Company agreed to repay the amount thereof with interest at

the rate of 4% per annum, but only when, if and to the extent that there were funds available therefor, in accordance with the plan agreed upon (R. 382-385).

The evidence clearly shows that at the time that the notes were given by Waterhouse Company, the estimated losses, based on an appraisal of individual assets, which leaned toward setting up as large a reserve as possible, were approximately $260,000.00 less than the reserve actually set up (R. 496-498). In other words, after an appraisal was made and specific reserves set up for each item, there still remained an excess of assets over liabilities of approximately $260,000.00 in addition to the $400,000.00 fund set up, and, if the assets had been liquidated at their appraised value on that date (February 14, 1931) the noteholders would have been paid in full (R. 496-498, 554). Thereafter conditions in the community took a turn for the worse and, by the end of 1932, it became apparent to American Factors that by reason of the further reduction in the value of the assets out of which the notes were to be paid, the note held by it was valueless and it was charged off as a loss on its books (R. 413-414, 468, 514, 543). Accordingly, in the computation of its taxable net income for the calendar year 1932, American Factors deducted said sum of $50,000.00 as a bad debt (R. 394-395).

The judgment of the court denied the deduction of said amount as either a bad debt or as a loss sustained, pursuant to its opinion and findings of fact and conclusions of law.

The relevant portion of the opinion relating to the issue of the deductibility of the Waterhouse Company loan is as follows:

> "(2) In 1931 this taxpayer advanced the sum of $50,000 to H. Waterhouse Trust Company, Ltd. in the hope of aiding, with the help of others, the trust company from closing its doors due to its insolvent condition, which insolvency was known to the taxpayer. The following year the loan was written off the taxpayer's books as a total loss and deducted as a bad debt in its gross income tax return for that year. It claimed that the loan, while somewhat speculative, was made in good faith and supported by a promissory note. The note contained a proviso, as follows:
>
> " 'Payment of principal and interest to be made only when, if and to the extent that there shall be funds available therefor as set forth in letter of this date from the payor to the payee.'
>
> "This deduction claim is disallowed." (R. 60-61).

The findings of fact relevant to this issue are those numbered XVIII to XXIX. With the exception of Finding of Fact No. XXVIII, all the others set forth facts which were stipulated by the parties (R. 79-97).

Finding of Fact No. XXVIII, which is a conclusion of law rather than a finding of fact and with which issue is taken reads as follows:

> "The note given by the Henry Waterhouse Trust Company to American Factors, Limited, in acknowledgment of the contribution of $50,000 made by that company in 1931 to the Henry

Waterhouse Trust Company was contingent as to payment, being subject to such conditions as to render it non-negotiable at the time it was made and at all times thereafter, and without negotiable value from the time it was made. The considerations in payment for the contribution flowed to the payee at the time it was made—the protection of the commercial community, sympathy toward the Henry Waterhouse Trust Company clients who could ill afford to lose, and other commendable desires and motives of helpfulness and security, but there was no attempt to show and there is no evidence of record which would support a finding of fact that American Factors, Limited, would have suffered any loss had it not attempted to keep the Henry Waterhouse Trust Company a going concern." (R. 96).

The conclusions of law relating to this issue are numbered V and VI, and read as follows:

"V.

"The payment of $50,000 made to the Henry Waterhouse Trust Company in 1931 by plaintiff was just a contribution. The note given by the Henry Waterhouse Trust Company in 1931 to plaintiff in acknowledgment of that contribution was contingent as to payment, being subject to such conditions as to render it non-negotiable and without any negotiable value at the time it was made and at all times thereafter, and therefore it could not be dealt with as a debt, and the Commissioner of Internal Revenue did not err in disallowing plaintiff a deduction therefor as a bad

debt in computing plaintiff's taxable net income for the calendar year 1932." (R. 102-103).

"VI.

"No part of this contribution of $50,000.00 was deductible as a bad debt, ascertained to be worthless and charged off within the taxable year 1932 within the terms of Section 23(j) of the Revenue Act of 1932 or as a loss sustained during that taxable year not compensated for by insurance or otherwise, within the terms of Section 23(f) of the Revenue Act of 1932, and accordingly no part of said contribution was properly allowable as a deduction in computing plaintiff's taxable net income for the calendar year 1932." (R. 103).

The conclusions of the court, set forth in its opinion, the findings of fact and the conclusions of law, relating to this issue can be summarized as follows:

First: That the payment of the $50,000.00 to Henry Waterhouse Trust Company was just a contribution. (Conclusion of Law No. V, R. 102);

Second: That the note in acknowledgment therefor was contingent as to value; that it contained conditions which gave it no negotiable value. (Finding of Fact No. XXVIII, R. 96);

Third: That the consideration for the note was the protection of the commercial community, sympathy towards clients of Henry Waterhouse Trust Company, and other commendable desires and motives for helpfulness and security. (Finding of Fact No. XXVIII, R. 96);

Fourth: That there is no evidence, nor was there any attempt to show that American Factors would suffer a business loss if Henry Waterhouse Trust was not kept a going concern. (Finding of Fact No. XXVIII, R. 96); and

Fifth: That there never was a collectible debt, but merely a contingent or speculative gift, even though it may have accomplished the purpose for which it was intended, namely, extending the life of Henry Waterhouse Trust (Conclusion No. V, R. 102-103).

(A) The sum of $50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a bad debt, determined to be worthless, and charged off within the tax year 1932.

Section 23 of the Revenue Act of 1932 pertaining to the deduction of bad debts is as follows:

> "(j) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction."

The evidence is clear and undisputable that American Factors did not intend to make a gift or a contribution to Waterhouse Company. Findings of Fact Nos. XVIII to XXVII, inclusive, which are based almost entirely upon the stipulation of facts of the parties, make clear that Finding of Fact No. XXVIII, which in truth and in fact is a conclusion of law at-

tempting to interpret the preceding findings of fact, is not justified by the facts therein set forth, nor by the evidence in the case.

The very fact that so elaborate an agreement was drawn up, under which Bishop Trust Company, Limited, was required to keep separate records of the assets of Waterhouse Company and to make accountings to the noteholders (R. 87-88), that there was an advisory committee representing the noteholders who met constantly with the officers of Waterhouse Company and consulted and advised with them in connection with the liquidation of the assets, the settlement of claims, and other matters relating to the property of Waterhouse Company (R. 388-390), indicates very strongly that there was a reasonable expectation of getting some return on their notes.

Finding of Fact No. XXI sets forth that under the plan proposed and adopted, the assets and liabilities of Waterhouse Company were to be liquidated and any excess of assets over liabilities, after the reimbursement of Bishop Trust Company, Limited, for additional amounts that it might be required to advance, was to be returned pro rata to those who had advanced moneys to the $400,000.00 fund together with interest (R. 81-84).

Finding of Fact No. XXIV sets forth an outline of the plan in letters, which were sent to each of the noteholders, setting forth the conditions under which the amounts paid in were to be returned to them. There is also set out that an advisory committee of

the noteholders was set up to pass on matters of importance relating particularly to the amount of reimbursement ultimately to go to the noteholders, the matter of sales of stocks and bonds of Waterhouse Company, and the compromise of claims by and against said company (R. 84-90).

Finding of Fact No. XXVI sets forth that the auditor's report showed that the assets exceeded the liabilities by $680,000.00, which was set up as a contingent reserve for losses; that that amount included a cushion of $260,000.00, representing an amount placed in the loss column on schedules prepared covering the individual receivables on the books, which amount was placed in the special contingent reserve after Bishop Trust Company, Limited determined to pay nothing for the stock, so that the assets and liabilities, including the reserves, would balance and the books would show that Bishop Trust Company, Limited should pay nothing for the stock (R. 91-94).

The evidence of Sherwood Lowrey, then treasurer of American Factors, is to the effect that American Factors believed that the note would be repaid (R. 474); that the note was reviewed at the end of 1931, together with all other receivables, and that at that time it was considered good (R. 466-467).

The evidence of E. J. Greaney, independent C.P.A., is that he was consulted with respect to Waterhouse Company, whose assets were deemed to be frozen, and he was asked to evaluate the assets as of January 31, 1931 (R. 487-490); that he computed the expected

losses (R. 495) and, after preparing schedules covering every individual receivable, the sum of $260,000.00, as a cushion, was added to take care of losses over and above the amount shown on the schedule (R. 497-498); that his work was done in conjunction with officers of Bishop Trust Company, Limited, who were severe in their views of collectibility and whose judgment was no doubt influenced by the fact that they tried to make the losses appear as great as possible (R. 489-490, 499-500). It was the opinion of Mr. Greaney that Waterhouse Company was not insolvent, since the value of its assets exceeded its liability (R. 505-506).

Mr. A. L. Castle, who represented his father who was one of those who contributed to the loan to Waterhouse Company, testified that there was no doubt of repayment of the notes (R. 511); that he served on the advisory committee and that the committee constantly examined the various accounts of Waterhouse Company with Mr. W. A. White, one of the officers of Waterhouse Company, who was in charge of the liquidation, and followed closely with him the liquidation of its assets from time to time (R. 512-513).

Mr. Arthur L. Dean, then a director of Alexander & Baldwin, Ltd., which was another of the lenders, testified that while the loan was possibly not a good investment type, there were other considerations in making the loan, and that it was expected that all or a part of the amount would be returned; that although it was known that a risk was being taken, he expected to get money back on the loan (R. 532-533).

The report of the Bank Examiner of the Territory of Hawaii states that after the company was taken over by Bishop Trust on February 14, 1931, it had sufficient assets on hand to meet all liabilities (R. 554).

There is nothing in the record to justify the conclusion of law that the $50,000.00, paid by American Factors to Waterhouse Company in 1931, was just a contribution. Likewise, there is nothing in the record to sustain a finding of fact or conclusion that the note was either contingent as to value or that conditions attached to it gave it no negotiable value. The evidence, as pointed out above, was that the persons who knew most about the transaction considered that while some risk was taken in the loaning of the money, and while it may not have been a good investment risk, nevertheless all expected repayment. While it is true that the fact that a note is only repayable out of a particular fund may diminish its value, nevertheless there is nothing in the record that would indicate that this particular note had no value. On the contrary, the record shows that the persons involved believed it to have a value.

In the case of the *Clay Drilling Co. of Texas v. Commissioner of Internal Revenue,* 6 T.C. 324, there was in question the deductibility of bad debt losses. The amounts charged off as bad debts were amounts that were admittedly owed to the taxpayer originally. However, an agreement was thereafter entered into under which the taxpayer agreed to pay certain commissions to the debtors and apply a certain portion

of the commissions payable to the liquidation of the indebtedness. The agreement further provided that the taxpayer would recover said indebtedness only in this manner, and that the debtors would not be personally liable for the payment of the debts except out of the share of the commissions which accrued.

The Commissioner contended that the accounts did not represent debts which were due taxpayer at the time they were charged off. He does not dispute that the accounts, when originally incurred, did represent debts, but contends that by the contract the indebtedness was cancelled and forgiven and no longer existed as a debt. The basis for the contention was that the contract in question provided a method of payment to the corporation of the indebtedness by means of commissions on certain drilling contracts, and the contract provided that the indebtedness was payable only out of the commissions and was not to be construed as a money or personal obligation payable by the debtors. The Commissioner claimed that in agreeing that the accounts were not to be construed to be a personal obligation they ceased to be debts.

The court said that if that is true, the Commissioner should prevail because the taxpayer would then have no debts to become worthless in the taxable year and, therefore, nothing to deduct. The court, however, found that those debts were not cancelled or forgiven by the terms of the contract; that the debts continued to exist, but payable only in the manner agreed upon, and the court stated, on page 331:

"It seems to us that the debts of the Herschbachs to petitioner continued to exist, payable, it is true, only in the manner agreed upon. We know of no law which is to the effect that a debt is canceled and forgiven merely because the manner of its payment is restricted and it is agreed that the debtor shall not be personally liable if the debt is not fully paid in that manner. Both parties concede that they know of no case exactly in point. Our search has not disclosed any. In *Riverview State Bank,* 1 T.C. 1147, we held, following several circuit court decisions cited in our report, that interest on special tax bills issued by the city of Kansas City, Kansas, which was levied and assessed by the city as a tax and was payable to the holders of the tax bills by the city, but was not payable out of the general funds of the city, was tax exempt as interest upon the obligations of a political subdivision of the state. In that case it was the Commissioner's contention that, since no obligation for payment of either principal or interest on the tax bills rested directly upon the city, they were not 'obligations' of the city within the meaning of the statute. We held against such contention. Of course the question we have here to decide is entirely different from the question which was present in the *Riverview State Bank* case, and yet we think the underlying reasoning in that case is of some help here. In some earlier cases involving the same question of exemption from taxation which we had in the *Riverview State Bank* case we had held that the bonds were not exempt because they were payable only out of special taxes and not unconditionally payable by the municipality—therefore, were not 'obligations' of the municipality within the mean-

ing of the applicable statute. We were reversed in some of these cases, the Circuit Court of Appeals holding that the bonds were 'obligations' of the municipalities even though payable only out of special tax bills and in no other manner. . . .

"Along somewhat the same line of reasoning, we think it is reasonable to hold that these accounts due by the Herschbachs to petitioner *continued to be debts or obligations owed by the Herschbachs to petitioner, even though payable only in a special way and not out of the debtor's 'general funds,' so to speak. . . .*"[1]

The same would be applicable to the present case. The mere fact that the notes were payable in a special way would not prevent the notes from constituting debts of the Waterhouse Company which could be the proper subject of a tax deduction at the time they were determined to be worthless.

In *Western Woodwork & Lumber Co. v. Commissioner,* 6 T.C.M. 504, taxpayer's president owned a lot and proposed to a building contractor that he build a house on the lot and, when the house was sold, taxpayer's president would be reimbursed in an agreed amount for the lot. The builder agreed to this if the taxpayer would furnish the lumber and mill work and if the builder's liability to pay would be limited to paying taxpayer said amount from the proceeds of the sale of the house when made. This agreement was accepted by taxpayer. In 1929 taxpayer received a note from the builder bearing interest, but it was

[1]Emphasis supplied.

agreed that he would not be liable on the note except to pay the same out of funds received from the sale of the house. The builder tried to sell the property, but failed to do so until January, 1943. In 1935 the builder had informed the taxpayer that he was ready to disclaim all hope of profit in the house, and offered to deed the same to taxpayer free of any claim. The taxpayer rejected this offer because he considered that the house with a mortgage on it was a liability. The taxpayer claimed the loss in 1943 when the house was sold and it received only a small payment out of the proceeds. This claim was disallowed by the Commissioner. The Tax Court upheld the Commissioner's determination, but not on the grounds that no debtor-creditor relationship existed because taxpayer had only a contingent claim as contended by the Commissioner, but because the worthlessness of the bad debt was established in 1935.

Here again is a case where the contingency that the fund from which the note was payable might prove insufficient to enable the payment to be made did not deprive the note of its character as a debt subject to being charged off and deducted as a bad debt when it became worthless.

It must be self-evident that the mere fact that the note was not negotiable does not necessarily mean that it had no value and no further point need be made of any implications that may arise from the court's characterization of the note as having no negotiable value. So long as there remains a reasonable expectation of repayment of a note, the note has value

whether it is negotiable or merely transferable by assignment.

With regard to the consideration for the making of the loan as set forth by the court, namely, the protection of the commercial community, sympathy towards clients of Waterhouse Company, and other commendable desires and motives for helpfulness and security, it is quite apparent that this finding or conclusion would be immaterial in determining the deductibility of the loan. It is well settled that the motives for advancing money or for lending money are not important in determining whether a payment is or is not a loan which can be the subject of a tax deduction as a bad debt. *Cooper-Brannan Naval Stores Co. v. Commissioner of Internal Revenue,* 9 B.T.A. 105, 108.

It is also clear that it is not the province of the court to inquire into the wisdom of the loan. It is only necessary for the taxpayer to establish the fact that the amounts advanced were ascertained to be worthless and charged off within the taxable year. *Holmes Ives v. Commissioner of Internal Revenue,* 5 B.T.A. 934, 936, and *Roy Nichols v. Commissioner of Internal Revenue,* 17 B.T.A. 580, 584, in which latter case it was held that a debt was deductible even though the financial condition of the debtor was known by petitioner to be precarious at the time the loan was made and so remained at all times thereafter, but the court said that the money was loaned under a promise to repay and that it was not a gift.

The evidence, as summarized above, indicates clearly that all the parties believed that the note in question represented a collectible debt, despite the so-called finding of the court to the contrary. The evidence conclusively shows that the payment of $50,000.00 to Waterhouse Company was not a contribution or gift, and that it was undoubtedly deemed to be collectible, and there is nothing in the record that would indicate otherwise nor is there anything in the record to indicate that there was not a reasonable expectancy that the assets would be sufficient to permit the repayment of a part, if not all, of the amounts represented by the notes. Further, the mere fact that the note was not negotiable, or that it contained conditions which limited its payment out of a particular fund, would not deprive the note of its character of representing a debt or obligation of the company which could be the proper basis of a deduction as a bad debt.

The only question is whether in truth and in fact a loan was made which constituted a debt on the part of the borrower and which could be the subject of a bad debt loss deduction. The evidence shows conclusively that it was such a loan, and the deduction as a bad debt should be allowed at the time said note became worthless.

That the note was ascertained to have become worthless in 1932 and was charged off as a bad debt in that year, is amply justified by the evidence.

Sherwood Lowrey, treasurer of American Factors, testified that in accordance with their usual procedure,

all the receivables were reviewed each year; that at the end of 1932, after a full examination of the matter and a discussion with various people who were familiar with the matter, the conclusion was reached that the note was valueless and it was charged off the books (R. 466-471).

Carl Linden, who was tax advisor and advisor in connection with accounting procedure of both American Factors and Alexander & Baldwin, another of the noteholders (R. 540-541), testified that after examination and discussion with various persons, the conclusion was reached that there was no possibility of recovery on the note (R. 543).

The bank examiner's report of the condition of Waterhouse Company at the close of business December 31, 1932, contained the statement, "An analysis of the various asset and liability accounts of the company made by us as at December 31, 1932, disclosed according to our figures, an insufficient amount of assets to meet the remaining liabilities." (R. 554).

Alfred L. Castle testified that a restudy was made of the assets of Waterhouse Company in 1932; that a letter (Ex. M, R. 413) was sent to each of the noteholders advising them that a reappraisal disclosed that its liabilities exceeded the value of its assets by a very considerable amount, which statement, Mr. Castle testified, was true so far as could be ascertained, and that he had come to the conclusion, as a result of his study, that the note was worthless and should be written off (R. 512-515).

It is, therefore, respectfully submitted that the note became worthless in 1932; was properly ascertained by American Factors to have become worthless after reasonable investigation and study; that the note was charged off as a bad debt in that year and that this deduction is a proper one and should be allowed in the computation of the income tax liability of American Factors for the calendar year 1932.

(B) If not deductible as a bad debt, the sum of $50,000.00, representing the amount paid to Waterhouse Company in 1931, was deductible as a loss sustained, or as an ordinary and necessary expense of American Factors in 1932.

Section 23 of the Revenue Act of 1932 providing for the deduction of losses by corporation is as follows:

> "(f) *Losses by Corporations.*—Subject to the limitations provided in subsection (r) of this section, in the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise."

Section 23 of said Revenue Act providing for the deduction of ordinary and necessary expenses is as follows:

> "(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, . . ."

In denying the alternative claim of American Factors that the deduction of $50,000.00 should be allowed as a loss or an ordinary and necessary expense of do-

ing business if it were not allowable as a bad debt, the only finding of the court or statement in the opinion was to the effect that there was no evidence or attempt to show that American Factors would suffer a business loss if Waterhouse Company were not kept a going concern (R. 96). This conclusion is likewise at odds with the record in the case.

Sherwood Lowrey testified that it was the opinion of the business interests in the community that it might be disastrous to the community as a whole if the Waterhouse Company failed (R. 465) and, again, that various ones involved concluded that it was to the best interest of the community and, therefore to American Factors, that Waterhouse Company be assisted by the loan (R. 474).

Mr. Dean testified that one of the purposes of the loan was to maintain the integrity and stability of the basic business enterprises of the Territory; that this was a small, isolated and closely-knit community; that it was felt it would be a major disaster, the ramifications of which could not be foreseen, if one of the trust companies was unable to meet its obligations (R. 527).

Further, the evidence in the record specifically set forth in Finding of Fact No. I (R. 67) showing the large stake of American Factors in the business of the Territory, would make it apparent that the failure of Waterhouse Company could not help but adversely affect the business interests of American Factors, as well as other businesses in the Territory.

In *Robert Gaylord, Inc. v. Commissioner of Internal Revenue,* 41 B.T.A. 1119, 1127, the petitioner was a Missouri corporation engaged in the business of manufacturing, selling and shipping containers, with its principal office in St. Louis, Missouri, where a large portion of its business was done. In 1931, one of the four leading banks in St. Louis experienced a silent run, during which withdrawals of approximately a million dollars a day in excess of deposits were being made. At that time the banking situation in St. Louis was acute, many depositors were worried over the safety of their deposits, and runs on banks were frequent. The Finance Commissioner of Missouri, after an examination of its affairs, found that the bank would probably be unable to pay its current liabilities and informed the officers of the bank and the members of the St. Louis Clearing House Association that unless it could be merged or consolidated with some other bank in St. Louis, he must order it closed and appoint a receiver to liquidate it. In order to avoid the serious financial crisis which would result from the closing of the bank and the appointment of a receiver, another bank was urged to take over the assets and assume its liabilities. That bank agreed that if it were furnished a guarantee against loss in an amount aggregating $2,000,000.00, it would take over the assets and assume the liabilities. The member banks of the St. Louis Clearing House Association agreed to participate in the guarantee fund up to $1,250,000.00. The officers and representatives of other businesses in St. Louis, including the petitioner, were called together, informed

of the situation and the terms under which the other bank would be willing to assume the liabilities of the distressed bank, and were informed that the general banking situation was getting acute; that if the bank were allowed to fail it would seriously affect all business, industry and banking in the city; that failure of the bank would result in a general run on the various banks in the city and, possibly, the failure of some of them; that while the bank was requiring a guarantee of $2,000,000.00, it was believed that the loss to be sustained would be covered by the capital and there probably would be no occasion to require payment by those who subscribed to the guarantee fund.

The petitioner subscribed $15,000.00—deposited that amount and received a certificate of deposit in 1932. In 1936 petitioner was informed that appraisals of the remaining unliquidated assets showed that such assets would be insufficient to satisfy the liabilities of the bank that had been taken over. On the basis of the appraisal, petitioner surrendered its certificate of deposit in order to prevent the necessity of actually selling the remaining unliquidated assets which might involve further losses on quick liquidation.

The Commissioner contended that the petitioner had merely made a voluntary contribution; that it participated in a rescue party purely as a matter of civic pride; that the amount was not paid as an ordinary or necessary expense of carrying on its trade or business.

The court said (p. 1122) that petitioner's argument in connection with its claim that the amount is de-

ductible as a loss, a contribution, or a debt ascertained to be worthless, is not without substantial merit. However, the court stated its opinion that the issue may be determined by ascertaining whether or not the expenditure constituted an ordinary and necessary business expense.

The testimony of the president of petitioner as to why it signed the agreement was that the businessmen were trying to save the situation; that there were rumors going around and that the company had quite an equity in the picture there; that there were accounts receivable, bank balances, and that he felt that the closing of the bank would adversely affect his business.

The court went on to say that the expenditure in question was deemed by the taxpayer to be necessary for the protection of its own business. The effect of the failure of the bank upon petitioner's business might well have been considerable.

The court further went on to say that banks and financial institutions were dependent, first, upon their own assets, and secondly, upon such assistance as they might receive in times of stress from their officers, directors and stockholders, from other banks, and from corporations and individuals who came to their rescue either as a gesture of friendship or, more frequently, as a matter of self defense. The plan devised and followed by the banks and business men of St. Louis, or some modification or variation of it, was being carried out in many sections of the country.

Accordingly, it held that the amount in question was deductible as an ordinary and necessary expense of carrying on petitioner's trade or business.

To the same effect is *Moloney Electric Co. v. Commissioner of Internal Revenue,* 42 B.T.A. 78, involving another guarantor to the payment fund involved in the *Gaylord* case, *supra.* The court held that the same conclusion must be reached as in the *Gaylord* case. Although the evidence was not as extended as the evidence in the *Gaylord* case, the court was of the opinion that judicial notice may be taken of the fact that the period was a very critical one in the banking situation generally; that, as stated in the *Gaylord* case, bank failures in 1931 were twice as numerous as they had been during the preceding year; four times as numerous as during the year 1929, and six times as numerous as during the average year in the predepression era; that the expenditure of the relatively small amount of money by the petitioner under the circumstances disclosed, supplemented by the matters as to which the court took judicial notice, constituted an ordinary and necessary expense of carrying on its trade or business.

To the same effect is *First National Bank of Skowhegan v. Commissioner of Internal Revenue,* 35 B.T.A. 876.

That financial institutions were in a precarious condition in 1931 is a well known fact of which the court can take judicial notice. That an organization together with the companies for which it acted as agent had

almost two million dollars on deposit in banks of the Territory, which carried on many businesses which had a capital and surplus of about $16,000,000 and was agent for other businesses having an aggregate capital and surplus of more than $48,000,000.00 (R. 375-376), would suffer a great loss if there should be a serious upset in the financial conditions in the small, closely-knit community in which it did business, would seem to be self-evident.

It is respectfully submitted that from the known facts of business conditions at the time, the cases here cited, and the facts set forth in *Bishop Trust Company, Limited v. Commissioner of Internal Revenue,* 36 B.T.A. 1173, and *Bishop Trust Company, Limited v. Commissioner of Internal Revenue,* 47 B.T.A. 737, with reference to the loan here in question, the conclusion is inescapable that if the loan of $50,000.00 to Waterhouse Company is not deductible as a bad debt in 1932, it is deductible as an ordinary and necessary expense of doing business of American Factors in that year.

CONCLUSION.

It is therefore respectfully submitted that American Factors is entitled to the deduction of the amount of $396,812.50, of Hackfeld litigation expenses reimbursed to the co-defendants, as an ordinary and necessary expense in computing its taxable net income for the calendar year 1932, and that American Factors is entitled to deduct the amount of $50,000.00, advanced

to Waterhouse Company, which became uncollectible in 1932, as a bad debt, as a loss sustained in that year, or as an ordinary and necessary expense of doing business in that year.

Dated, Honolulu, T. H.,
March 17, 1950.

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